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Host country marketing culture and foreign direct investment

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Abstract

This paper attempts to analyze the impact of host country competitive environment on the level of FDI that the host country receives. Specifically, we consider two features of the competitive environment: buyers' sophistication and firms' degree of customer orientation. Using a large set of panel data and controlling for economic causes along with sources of risk, we find that FDI stocks in a country decreases with the degree of buyer sophistication and increases with the degree of customer orientation of firms. These results suggest that target country competitive environment is an important factor that determines where FDI goes.

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Keywords: International investment; multinational firms; international marketing; foreign direct investment

1. Introduction

The aim of this paper is to investigate the importance of marketing in the determination of foreign direct investment (FDI). According to Word Bank (2013a), total FDI net inflows in the world was about 1.7 trillion dollars in 2011 [1]. The highest FDI receiving countries are China and the US, which received 280 and 257.5 trillion dollars of FDI in 2011 respectively. It is not surprising that one of the fastest growing economies of the world since the late 1970s, China, and the biggest economy in the world, the US, are on the top of the list. The size and the growth of the host country economy are certainly among the important determinants of FDI as many studies confirmed. The literature on FDI determinants counts various factors, other than the growth and the size of the host country economy, such as the growth and the size of the source country economy, the distance between the source and the

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host countries, host country endowments of natural resources, the cultural proximity between both countries, institutional factors, political and economic risks of both countries, trade between both countries, etc. as possible determinants of FDI. To our knowledge specific marketing variables have never been investigated as possible determinants of FDI. In this study we analyze the effect of two marketing variables, namely degree of customer orientation and buyer sophistication, on FDI stocks.

The total FDI net inflows in the world has been steadily increasing throughout the 1990s since 1991, but it decreased in the periods between 2000 and 2003 and between 2007 and 2009. It went down from 1319 billion dollars in 2000 to 573 billion dollars in 2003, and then it sharply increased and reached to 2472 in 2007. It decreased two consecutive years after 2007 and became 1163 billion dollars in 2009 and then started to increase again, reaching to 1724 billion dollars in 2011 [1]. The volatility of FDI inflows in 2000s might be attributed to early 2000s recessions and the financial crisis of 2007-2008. Assuming that globalization will continue to increase capital mobility as well as the likelihood of global crises, we might expect both the increase of further FDI in the world and its higher volatility in the near future. This makes it further interesting and valuable to make use of the latest available data on FDI to test the current validity of traditional determinants and search for new explanatory variables as possible determinants of FDI.

Our analysis focuses on the effects of marketing variables of degree of customer orientation and buyer sophistication on the level of FDI in the country. The variable of degree of customer orientation measures the way companies treat their customers. A high value of this variable indicates that companies are highly responsive to customers and customer retention whereas a low value indicates that companies generally treat their customers badly. The other marketing variable, buyer sophistication, measures how customers make purchasing decisions. A high value of this variable indicates that customers' purchasing decisions are based on a sophisticated analysis of performance attributes whereas a low value indicates that customers' purchasing decisions are based solely on the lowest price. It is fairly reasonable to expect multinational enterprises (MNEs) to take into account these attitudes of incumbent companies and customers in the host country when they decide whether to invest in that country.

The paper is organized as follows. In the next section we present a literature review, which might help us to emphasize the economic and institutional factors whose effectiveness in the determination of FDI has been supported by earlier research. The third section illustrates the model specification and the estimation procedure. It also describes the data used. In the fourth section, results are presented and interpreted.

2. Literature Review

FDI theory suggests numerous factors that potentially impact FDI in a country. In addition there is evidence that many of these determinants are highly contextual. That is, what host country factor attracts FDI depends on the motives for FDI, industry specific characteristics, and the function being performed by the MNE subsidiary [2]. Host country determinants include a broad spectrum of government policies, business facilitation practices, and economic factors.

A quick review of some literature on FDI determinants might help us to see which factors as determinants of FDI have been supported by earlier empirical studies. Bevan and Estrin (2004) aims to analyze empirically the determinants of inward FDI to the Central and Eastern European Countries by focusing on proximity, concentration advantages and factor costs [3]. They use panel data on bilateral FDI flows from individual source to host countries between 1994 and 2000. Their explanatory variables are GDPs of both source and host countries, the distance between the two countries, trade variable (host country imports from EU as a percentage of the country's GDP), unit labor costs in the host country, interest rate differential between the source and the host countries, risk variable which captures institutional development and economic and political risk, and an announcement dummy variable which indicates whether the host country has EU prospect. Random effect estimates indicate that gravity factors, GDPs and the distance between the countries, as well as unit labor costs are significant determinants of FDI. The empirical results also show that EU announcements about potential accession have significant and positive effects on FDI flows to transition economies.

Busse and Hefeker (2007) examine the impact of political risk and institutions on FDI inflows into 83 developing countries from 1984 to 2003 [4]. The results of their panel data analysis indicate that government stability, internal

and external conflicts, law and order, ethnic tensions, bureaucratic quality and, to a lesser degree, corruption and democratic accountability are important determinants of FDI. They conclude that these political risk and institutional indicators are the most important factors which MNEs consider when they make decisions about where to invest in developing countries.

While most studies of outward FDI focus on investments from developed countries, recently there have been some studies that examine FDI by developing countries. For instance, Buckley et al. (2007) investigate the determinants of outward FDI by Chinese multinational enterprises (MNEs) over the period 1984 to 2001 [5]. They try to understand to what extent established theoretical explanations of the MNEs can explain FDI from China. For Chinese firms' outward FDI, the authors consider three potential arguments: capital market imperfections, special ownership advantages of Chinese MNEs and institutional factors. Their data set includes 49 countries hosting Chinese outward FDI. The results of their panel data analysis show that, consistent with their expectation, absolute market size, cultural proximity to China, liberalization of Chinese outward FDI in 1992, and Chinese exports to and imports from the host country are associated positively with Chinese outward FDI. On the other hand, contrary to their expectations, they found that high levels of political risk are also positively associated with Chinese outward FDI.

Büthe and Milner (2008) argue that while government policies are important determinants of FDI, they are not sufficient to attract FDI into a country as the host country government could easily renege on its policies [6]. Instead, international agreements that bind a host country to liberal economic policies are more credible commitment regarding present and future economic policies. Based on this argument, Büthe and Milner (2008) present a framework that posits a positive relationship between GATT/WTO membership as well as the number of preferential trade agreements to which a country is party and FDI inflows as a percentage of GDP [6]. Their panel data analyses on FDI inflows to 122 developing countries provide strong support for their argument even after controlling for basic factors such as GDP growth, economic development, market size, trade openness, democracy and political stability and taking into account possible endogeneity.

Walsh and Yu (2010) analyze various macroeconomic, developmental, and institutional/qualitative determinants of FDI in a sample of emerging market and developed economics [7]. Using Arellano-Bond panel data estimator and data ranging from 1985 to 2008, for 27 advanced and emerging market countries, they examine the effect of variables such as openness, multilateral real exchange rate, inflation, the FDI stocks, real GDP growth and GDP per capita as well as institutional and qualitative variables. The paper concludes that investment decisions across industries in both advanced and emerging economies may have quite different determinants.

Differences in the importance of FDI determinants are not only observed in the context of different levels of country development. For instance, empirical determinants of bilateral FDI show substantial differences with respect to what factor is important. Given such disagreement, Blonigen and Piger (2011) use Bayesian statistical techniques to select the most important FDI determinants from a large set of factors [8]. Using three measures of FDI activity (FDI stocks, cross-border M&A and affiliate sales) for the dependent variable, their analysis shows that geographic distance, cultural distance, host as well as source country GDP, human capital and regional trade agreements have high inclusion probabilities. On the other hand, trade openness, host country business costs, infrastructure and institutions appear to have low probabilities of inclusion in the set of important FDI determinants.

Using a Bayesian approach and controlling for sample selection, Eicher et al. (2010) test several theories of FDI [9]. Their analysis of a large set of panel data provides strong support for host country market potential and mixed or weak support for the effect of trade agreements as well as vertical, horizontal and export platform FDI theories. On the other hand, knowledge capital which they measure with educational attainment does not seem to exert influence on FDI.

In her review of the literature on FDI determinants, Faeth (2009) evaluates nine theoretical models of FDI and derive the FDI determinants associated with each model [10]. As the empirical literature provide support for most of these determinants and associated models, she argues that empirical FDI studies should combine factors from a variety of theoretical models such as ownership advantages, market size and characteristics, cost factors, transport costs, protection, risk factors and policy variables. Our empirical specification concurs with this approach and takes into account economic as well as country specific risk factors (economic, political, legal). In addition to these

traditional factors, we consider the impact of two marketing related variables on the level of FDI that a country receives.

Specifically, we focus on degree of customer orientation of firms and buyer sophistication in host countries. For reasons that have to do with national culture and history (World Economic Forum, 2013), these factors could differ substantially across countries [11]. We believe that through their influence on inter-firm competition, these factors are important determinants of firm as well as country competitive advantages. For instance, firms focusing on fulfilling their customers' needs are more likely to be more innovative than those that do not pay attention to customers' needs and wants. If many firms try to compete by focusing on their customers' needs, we are more likely to observe better products and services and more efficient firms. Firms that lag behind in this sort of competition would probably cease to exist. Similarly, in countries, where buyers expect high performance and many feature in the products they purchase, there would be more intense competition among firms, which in turn help firms hone their competitiveness both at the local and the global level. Thus, customer orientation of firms and buyer sophistication are important determinants of how firms compete in a country. We assume that MNEs consider the competitive environment of countries in which they contemplate to invest, as country competitive environment as well as competitive advantage of local firms exerts an important influence on the prospect of foreign firms. Given this logic, we argue that degree of customer orientation of local firms and buyer sophistication in host countries should be included in an empirical specification of FDI determinants.

3. Data and Methodology

3.1. Sample

In order to conduct our empirical analyses we use a large panel data derived from several sources, including The World Bank, UNCTAD, and World Economic Forum's Global Competitiveness database. As we do not restrict our analysis to a group of countries, our panel comprises all countries for the years between 2005 and 2012. Due to missing data on some of our variables, we drop 84 countries from our sample, leaving us with cross-sectional data on a sample of 131 countries for an average of 5.5 years, resulting in 714 country-year observations. Although UNCTAD reports FDI data for more than 200 countries, the countries in our sample accounted for 96% of the world's FDI stock in 2011 [12]. Thus, our sample practically comprises the population of countries with FDI stocks in the years from 2006 to 2011.

3.2. Empirical Specification

The literature on FDI determinants focuses on either bilateral FDI flows between pairs of countries or inward FDI flows that a country receives as the left-hand side variable. We follow the literature on inward FDI flows that a country receives in specifying our empirical model. The FDI in a country is measured in terms of inflows as well as stocks. Both measures are positively skewed and have extremely high kurtosis. Our empirical specification focuses on the natural logarithm of a country's FDI stocks in a year as the dependent variable for two reasons: One is that unlike FDI inflows FDI stocks is always positive, hence natural log transformation does not cause loss of information in this variable. Second, there is at least as large variance in FDI stocks as there is in FDI inflows while there is around 90% correlation between the two variables. One potential problem with using FDI flows as a dependent variable in a regression equation is the upward trend in this variable that could cause serial correlation in the error term. In our estimates, we appropriately account for this possibility.

We assume that FDI occurs when the investment is deemed to create risk-adjusted value for the investing entity. Our literature review suggests that factors such as market size, cost-efficient labor, and natural as well as knowledge resources are sources of value. The potential value creation must be adjusted for risk factors such as economic, political-legal, social and bureaucratic institutions. Thus, our basic econometric model takes the following form:

$$\log (\text{FDI Stocks}_{it}) = \alpha + \beta_1 MS_{it} + \beta_2 NR_{it} + \beta_3 KR_{it} + \beta_4 \log(LE_{it}) + \Sigma^{8}_{k=5} \beta_k X_{kit} + \nu_i + \varepsilon_i \quad (1)$$

where *MS, NR, KR*, and *LE* indicate the host country's market size, natural resources, knowledge resources and labor efficiency, respectively. *Z'* indicates a set of control variables that includes proxies for quality of public governance, inflation, level of trade barriers and total tax rate in the host country. Subscripts *i* and *t* stand for country and year, respectively. The Greek symbol ν indicates country specific effect and ε is the idiosyncratic error term.

In our full econometric model, we add in a piecemeal fashion two marketing related variables to our basic specification. These are degree of *customer orientation* of firms and level of *buyer sophistication* in the host country. These variables are intended to capture the nature of the relationship between firms and customers in the host country.

3.3. Measurement

Our FDI data comes from the online version of UNCTAD database [12], which report FDI data in millions of US dollars at current prices and current exchange rates. *FDI Stocks*, our dependent variable, is measured as the value of the share of affiliates' capital and reserves (including retained profits) attributable to the parent enterprise, plus the net indebtedness of affiliates to the parent enterprises. In our estimates we use the natural logarithm of *FDI stocks*.

We use Global Competitiveness data to measure degree of customer orientation of firms, level of buyer sophistication, market size, knowledge resources, prevalence of trade barriers and total tax rate in the host country. In order to assess a country's competitiveness, The World Economic Forum collects data on more than one hundred country specific factors. The data on these factors is based on secondary sources, such as UNESCO, IMF, WHO, as well as primary sources [11]. This data is available for all years from 2006 to 2012.

The measure for *degree of customer orientation* is based on a single question that asks executives how companies in their country treat customers. This question requires a response on a scale from "1 = generally treat their customer badly" to "7 = are highly responsive to customers and customer retention". Similarly the measure for *buyer sophistication* is based on a single question that asks how buyers make purchasing decisions. This question as well requires a response on a scale from "1 = based solely on the lowest price" to "7 = based on a sophisticated analysis of performance attributes".

The measure for the *prevalence of trade barriers* is based on a single question that assesses the extent to which tariff and non-tariff barriers limit the ability of imported goods to compete in the domestic market on a scale from "1 = strongly limit" to "7 = do not limit". *Total tax rate* is measured as the combination of profit tax, total tax and contribution and other taxes, each in percentage of profits.

Market size in the Global Competitiveness Index is a composite measure that varies on a scale from 1 to 7 and is based on four proxies of domestic as well as foreign market size. By including foreign market size in our measure, we take into account economies that function as export platform for some FDI. Given the strategies and organization of multinational enterprises, we believe that accounting for foreign market size of a country better captures the market size of that country. The indexes that this measure is based on are domestic market size index, foreign market size index, GDP in terms of purchasing power parity and exports as a percentage of GDP [11 p.522].

Our measure of *knowledge resources* is based on both business sophistication and innovation scales that we derive from GCI. Business sophistication in a country is measured on a scale from 1 to 7, and is "the quality of a country's overall business networks and the quality of business firms' operations and strategies" [11 p.7]. As such, business sophistication scale is intended to capture the know-how, skills and capabilities that are embedded within organizations in a country. Innovation scale as well is measure on a scale from 1 to 7, and attempts to capture the technological innovation that is the result of factors such as investment in R&D and quality of and collaboration among research institutions [11 p.105]. We take the average of these two scales to arrive at our measure of knowledge resource, which could take values from 1 to 7.

To measure the quality of public governance, we use data derived from The World Bank's Worldwide Governance Indicators database. Worldwide governance indicators combine the views of a large number of enterprise, citizen and expert survey respondents from a total of 215 industrial and developing countries [13]. The database provides an estimate, standard error, lower and upper limit of each estimate, and the number of information sources for six governance indicators. These governance indicators are voice and accountability, political stability

and absence of violence, government effectiveness, regulatory quality, rule of law and control for corruption (for details on how these indices are measured see [13]). Our estimate of *quality of public* governance combines (sums) all of these estimates to arrive at an overall estimate for the quality of public governance.

Inflation data is taken from The World Bank database and it is measured by the consumer price index. As a measure for *labor efficiency* we use the inverse of the ratio of minimum wage to value added data derived from The World Bank database. In our estimates, we use the natural logarithm of this measure in order to reduce the effect of outliers in our data.

For *natural resources* in a country, we use The World Bank's data on natural resources rents measured in percentage of GDP. These rents are the sum of oil rents, natural gas rents, coal rents (hard and soft), mineral rents, and forest rents.

3.4. Estimation Technique

In this study we explore a balanced panel of data with an average of 5.5 years. One advantage of panel data is that one can both explore variation over units as well as variation over time and at the same time realize and estimate for unobservable individual (country) specific effects. There are two ways to model and estimate country specific effects. One is the within or fixed-effects model that explores the within variation (i.e., country specific variation over time). The other is random-effects model that explores both within and between (i.e., across countries) variation in the data. The fixed effect allows for a limited form of endogeneity in the model, i.e., consistent parameter estimates are possible even when individual specific effects are correlated with the independent variables in the model, whereas under the random effects, this correlation is assumed to be zero.

One of the most popular means to choose between these estimators is the Hausman test [14]. One problem with this test is that it requires that individual specific effects and idiosyncratic error are i.i.d. This assumption is invalid when the cluster robust standard errors are substantially different from the default standard errors for the random effect estimator [15]. According to Clark and Linzer (2013), given a short panel, the better model depends on the level of correlation between individual specific effects and the independent variables in the model [16]. They maintain that with a correlation less than 0.3 to 0.5, the random effect model should be preferred.

In our data, the between variation is significantly larger than the within variation. In fact, the within variation is not sufficient to arrive at consistent and efficient parameter estimates using the fixed effect estimator . Moreover, the correlation between our estimate of country specific effects and independent variables in our model is below 0.10 for all independent variables except for market size, for which the correlation is below 0.50. Thus, we favor the random effect model in our empirical analyses.

Our estimation methodology addresses one additional issue in our data. We have a dependent variable with upward trending time series. Any static estimator is likely to produce serial correlation in the idiosyncratic error term, seriously violating the assumption of i.i.d. normal errors. Thus, we assume that the error term in our model is correlated with its first lag and use Baltagi-Wu GLS estimator [17] for our random effect model.

Table 1. Summary Statistics

Variable	Mean	Std. Dev.	1.	2.	3.	4.	5.	6.	7.	8.	9.	10.	11.
1. FDI Stocks	9.9063	2.3018	1										
2. Buyer sophistication	3.6470	0.8838	0.72	1									
3. Customer Orientation	4.6161	0.7046	0.62	0.77	1								
4. Qual. of public gov.	0.7493	5.1626	0.61	0.72	0.71	1							
5. Market size	3.8055	1.1891	0.86	0.63	0.52	0.37	1						
6. Knowledge resources	3.7362	0.8067	0.74	0.86	0.86	0.82	0.63	1					
7. Natural resources	8.8764	13.8643	-0.09	-0.17	-0.25	-0.31	-0.09	-0.22	1				
8. Inflation	41.5784	914.2089	-0.05	-0.03	-0.06	-0.08	-0.03	-0.04	0.01	1			
9. Total tax rate	80.7177	66.7859	-0.26	-0.09	-0.10	-0.18	-0.10	-0.10	-0.03	0.00	1		
10. Labor efficiency	-0.2565	0.2351	0.18	0.22	0.24	0.26	0.09	0.24	0.08	-0.65	0.00	1	
11. Trade barriers	4.5794	0.7505	0.46	0.54	0.58	0.73	0.26	0.60	-0.22	-0.05	-0.16	0.25	1

4. Results and Discussion

Table 1 presents the descriptive statistics and correlations for all variables. Regarding our marketing related variables (customer orientation and buyer sophistication) we do not have a priori expectation as to the nature of their relationship with our dependent variable. On the other hand, the correlation between these variables and our dependent variable is high and significant which compels us to explore this relationship in a multivariate setting. Also note that all the other explanatory variables except inflation are significantly correlated with FDI stocks. The correlation between natural resources and our dependent variable appear to be significantly negative, suggesting that natural resources might have lost their attractiveness for FDI in recent years.

Table 2. Baltagi-Wu GLS (Random Effects) Estimates of the Determinants of FDI Stocks

	Model 1		Model 2		Model 3		Model 4	
	Coef.	p-val.	Coef.	p-val.	Coef.	p-val.	Coef.	p-val.
Buyer sophistication					-0.16565	0.002	-0.17810	0.001
Customer Orientation			0.11614	0.136			0.14753	0.058
Qual. of public gov.	0.08174	0.000	0.08404	0.000	0.08114	0.000	0.08400	0.000
Market size	0.74773	0.000	0.75734	0.000	0.76685	0.000	0.78093	0.000
Knowledge resources	0.70721	0.000	0.60604	0.000	0.85548	0.000	0.73796	0.000
Natural resources	0.00424	0.182	0.00446	0.159	0.00470	0.137	0.00503	0.111
Inflation	0.00008	0.120	0.00008	0.128	0.00008	0.132	0.00007	0.143
Total tax rate	-0.00442	0.000	-0.00442	0.000	-0.00418	0.000	-0.00416	0.000
Labor efficiency	-0.34438	0.202	-0.33020	0.221	-0.33392	0.213	-0.31523	0.239
Trade barriers	0.13722	0.016	0.12244	0.035	0.15646	0.006	0.13945	0.016
Constant	4.08247	0.000	3.94885	0.000	3.95268	0.000	3.77030	0.000
N	714		714		714		714	
i	131		131		131		131	
Wald Chi-sq (9)	833.74		845		860		878	
R-sq (within)	0.14		0.15		0.18		0.19	
R-sq (between)	0.83		0.83		0.82		0.82	
R-sq (overall)	0.82		0.82		0.81		0.81	
rho_ar	0.57		0.56		0.56		0.55	
sigma_u	0.76		0.76		0.76		0.76	
sigma_e	0.35		0.35		0.35		0.35	
rho_fov	0.82		0.82		0.82		0.82	
DW	0.99		1.01		0.99		1.01	

Table 2 presents the Baltagi-Wu GLS estimates (random effects GLS regressions with AR(1) errors) of our random country effects specification. We report four different estimates of our specification in order to demonstrate the consistency of coefficient estimates under various specifications. Model 1 in this table presents the estimate of our baseline specification. The Wald Chi-square test indicates that the model as a whole is highly significant with relatively high goodness of fit. In addition, the modified Durbin-Watson statistic implies that estimate of AR(1) disturbances is necessary as there is evidence of serial correlation in the error term. As far as the estimated coefficients are concerned, it appears that all explanatory variables, except natural resources, labor efficiency and inflation, are highly significant in the expected direction. It seems that FDI goes to and remains in countries with large market size and good public governance, and that are rich in terms of knowledge resources. Contrary to the tariff-jumping FDI hypothesis [18] the ineffectiveness of trade barriers seems to be positively related to FDI stocks, which imply that the more a country is open to foreign competition the more it receives and maintains FDI. On the other hand, higher tax rate appears to discourage FDI. One surprising result in this model is that the coefficient on labor efficiency, although negative, is not significant (two sided *p-value* = 0.202), and close to being marginally significant when the hypothesis test is one-sided (one sided *p-value* = 0.101). One possible explanation for this result might be that minimum wage is not reliable measure for labor cost.

Now we turn to the analyses of our marketing variables. We first add the degree of customer orientation of firms in the host country to our baseline model and present its estimate in Model 2 on the same table. Note that there is virtually no change in the point estimate and statistical significance of the parameters that make up the baseline specification. In addition, there seem to be a positive but statistically insignificant relationship between customer orientation and FDI stocks. Model 3 provides the estimate of our model when buyer sophistication is in the model. We first note that in this estimate as well the estimates on baseline coefficients are fundamentally the same as those in Model 1. Moreover, under this estimate there is a slight improvement in the Wald statistic. Regarding the coefficient on buyer sophistication, we notice that increase in buyer sophistication is negatively related to FDI stocks in a country (*p-value* = 0.002). That is, the higher the buyers' emphasis on a product's performance attributes the lower would be the FDI stocks in a country.

Model 4 presents the estimate of our model when both marketing variables are in the model at the same time. We first note that the coefficient estimates of our baseline variables remain the same both qualitatively and quantitatively. In addition, the coefficient on buyer sophistication is still significantly negative. On the other hand, the coefficient on the degree of customer orientation becomes statistically significant (*p-value* = 0.06) under this specification.

Overall, our estimates provide strong evidence that the general attitude of customers when making purchasing decisions in a country affects FDI in that country. Specifically, FDI appears to go up in countries where customers put higher emphasis on product cost rather than product performance and features. This result appears to be robust to controls for several factors that are related to FDI. In addition, our results provide partial evidence that FDI increases in countries where firms are sensitive to customers' needs and emphasize customer retention. Although the evidence on customer orientation of firms is inconclusive, our findings provide preliminary evidence that overall firms' marketing practices and buyers' behavior in a country are very likely to draw the attention of multinational enterprises considering investment in that country.

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